THE ECONOMIC SITUATION

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- **How long and deep will it be?**
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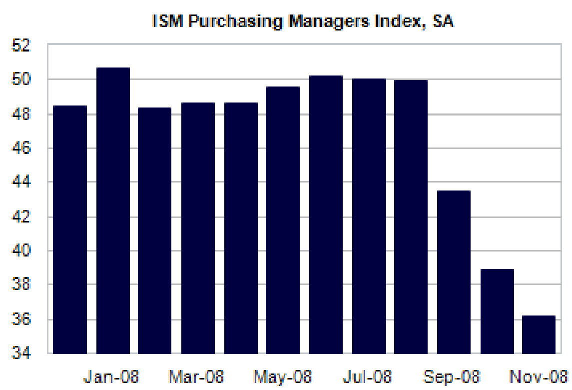
Recession 2008: It is now official.

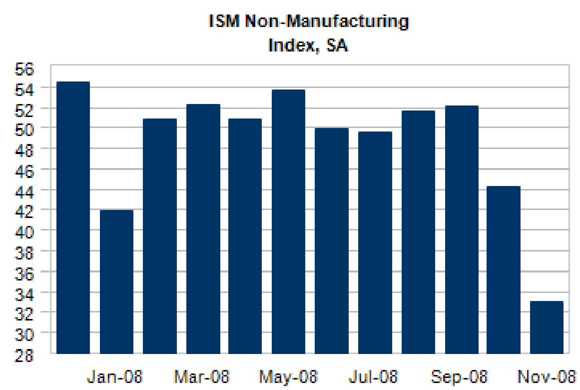
On December 1, the National Bureau of Economic Research's (NBER's) dating committee made it official. The U.S. economy went into recession in December 2007. No, there was not two consecutive quarters of negative GDP growth, but there was enough weakness in labor and consumer markets to turn the trick. The committee did not say when the recession would end, which is the point where a decelerating economy begins to grow again; that is not their business. The trough of the recession will be determined later. But keep in mind what the starting point means. This is the point where a growing economy has peaked and begins to sag. While the NBER announcement made it official, only the most remote hermit needed that message to know that the U.S. economy was swooning. Even so, the Dow-Jones average seemed to celebrate the news with one of its gigantic sell offs.

Though seldom is heard an encouraging word, weakness is still the best way to describe the national data that arrives daily. The November employment report that arrived on December 5 is a case in point. Not only were November data weaker than even the more pessimistic forecasters expected, but earlier data were revised downward. The U.S. unemployment rate rose to 6.5% from November's 6.1%. The fact that the U.S. labor force fell to a lower level in December due to the discouraged worker effect made the picture even uglier.

But not all of the new data are that ugly. Either because of, or in spite of, extraordinary steps taken daily by Washington economic doctors to inject power into the economy, we are beginning to see meaningful improvement in world credit markets. The falling London Interbank Offer Rate is signaling recovery of trust among major banks. Actions taken by the Fed to purchase mortgage-backed securities have led to sharply declining home mortgage rates and generated real relief to badly bruised housing markets. Mortgage refinancing with lower monthly payments are already emerging. Added to this are dramatically falling oil and gasoline prices fed by a stronger dollar that are generating the equivalent of a $200 billion increase in disposable income to consumers. But while there is some balm found in the data, the overall picture is still worse than just not pretty.

The next two data items from the Institute of Supply Chain Management, courtesy of economy.com, capture the essence of the overall weakness. Here we have readings for the economy's two components: Manufacturing and Services. The November data follow a pattern established when September manufacturing production slipped over the edge of a cliff. Manufacturing slipped first and then came services.



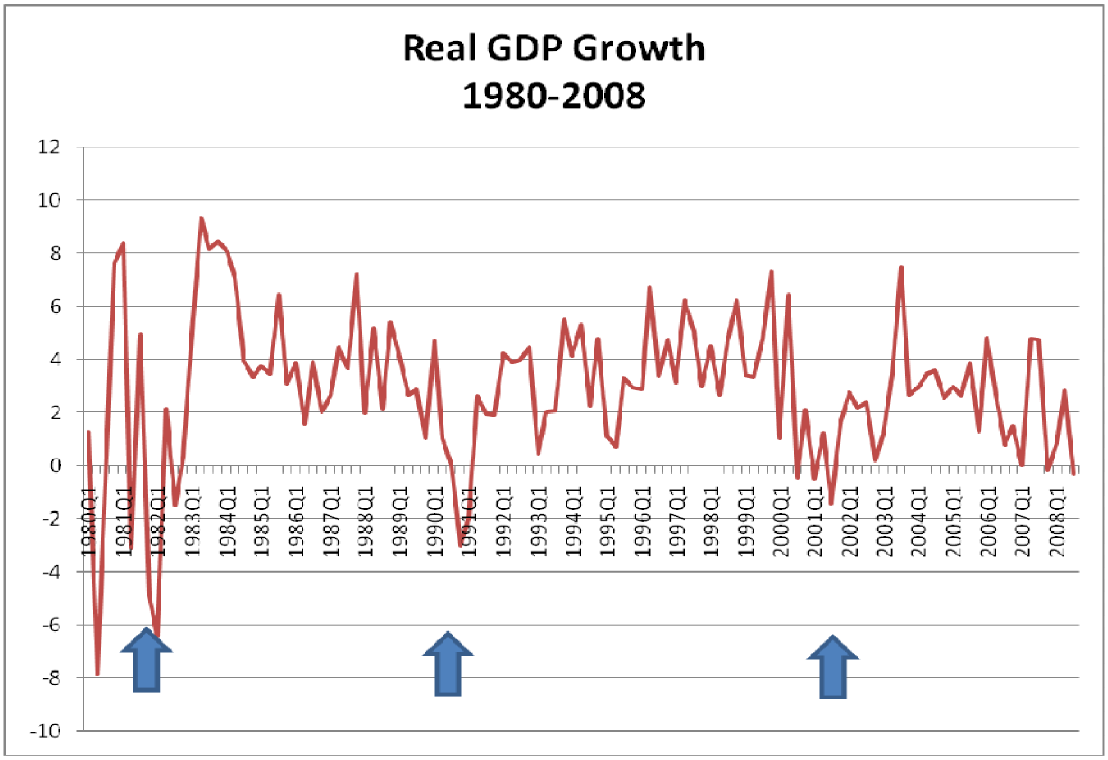


The wave of pessimism affecting forecasters is seen in downward revisions for 2009 economic growth reported in the next table. I call attention to the dates associated with the various estimates, the more current the estimate, the lower the 2009 number.

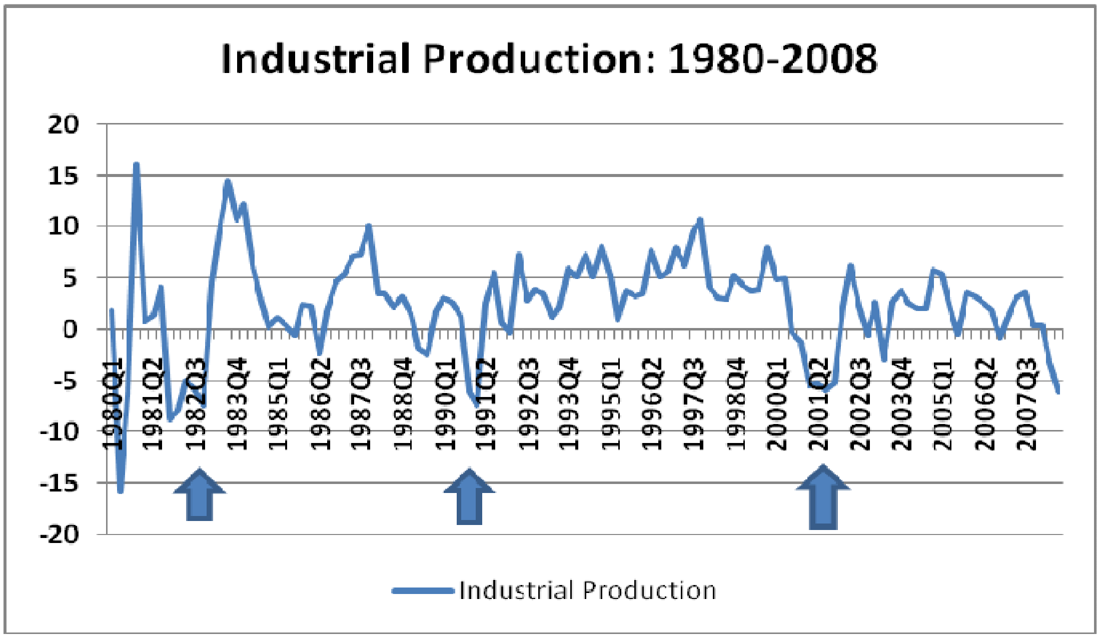
GDP Forecasts: 2008-2009 November 17, 2008		
Forecast	*2008*	*2009*
Blue Chip (September)	1.8%	1.5%
CBO (September)	0.9%	1.8%
World Bank (September)	1.1%	1.9%
IMF (October)	1.6%	0.1%
Economist.com (November)	1.4%	-0.2
Economy.com (November)	1.4%	0%
Wachovia (November)	1.3%	-1.0

Putting dimensions on a recession: how deep and how long?

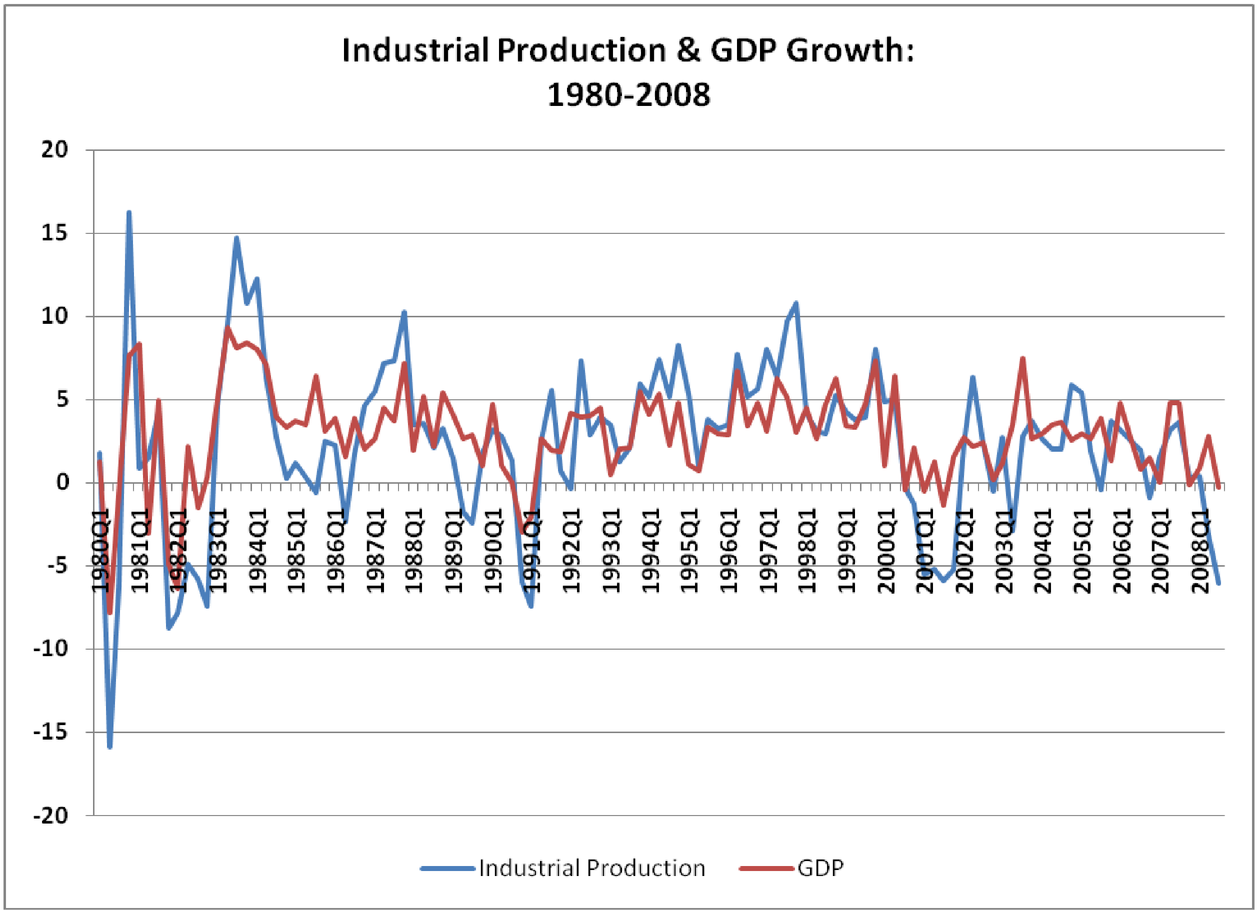
In my November Special Report, I provided an analysis of past recessions in an effort to put some dimensions on the current recession. The next chart shows GDP growth for the period 1980 to 2008. Three recessions are marked with blue arrows. In reviewing post-World War II recessions, I chose 1981-82 as the model for the current one. The 1981-82 recession, was generated deliberately in the Reagan Administration when Fed Chairman Paul Volker took ultimately successful action to purge inflation from the economy. With a heavy foot on the monetary brakes, Volker pushed the nation into one of the most severe recessions since World War II. It was deep and broad.



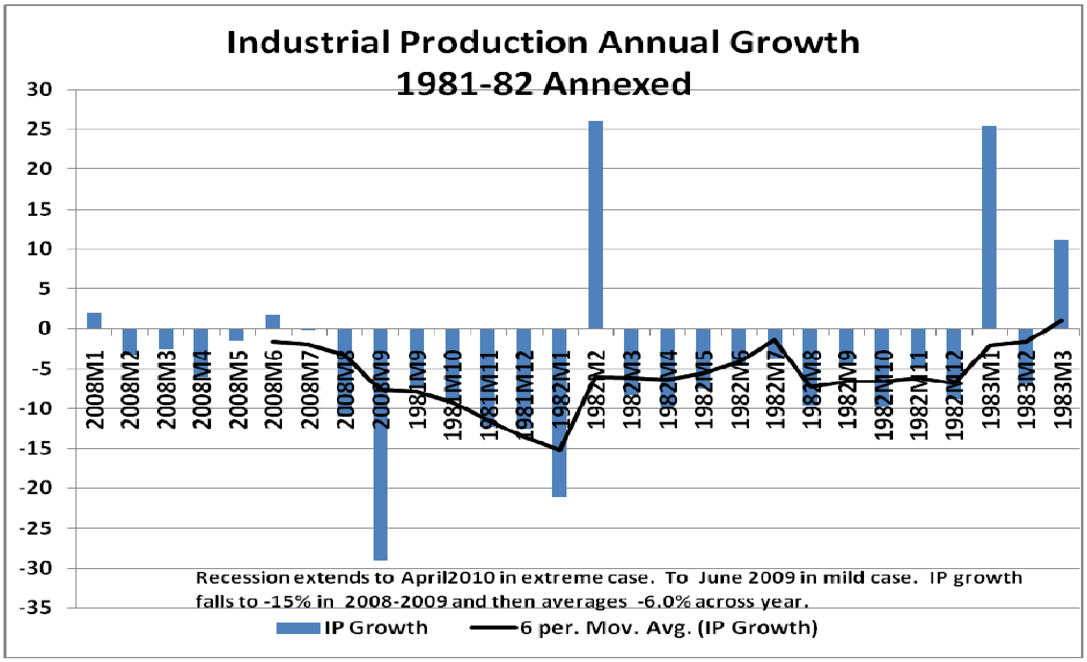
Industrial Production (IP) patterns are seen in the next chart. You will note that the IP swings are larger than the GDP swings, although the recession periods are about the same duration. A hint of the current recession is seen in the last observation, which crosses into negative territory.



The two time series are combined in the next chart. This enables us to see the different dynamics for GDP and Industrial production and also observe similarities in depth and duration of the three previous recessions. Industrial production growth is more volatile than GDP growth and exhibits deeper positive and negative swings. Along these lines, the 3Q2008 is instructive. IP growth is sharply negative; GDP growth, affected by the first round of rebates, is barely so.



To establish a picture, I annexed data from 1981-82 to the actual industrial production for the current period..

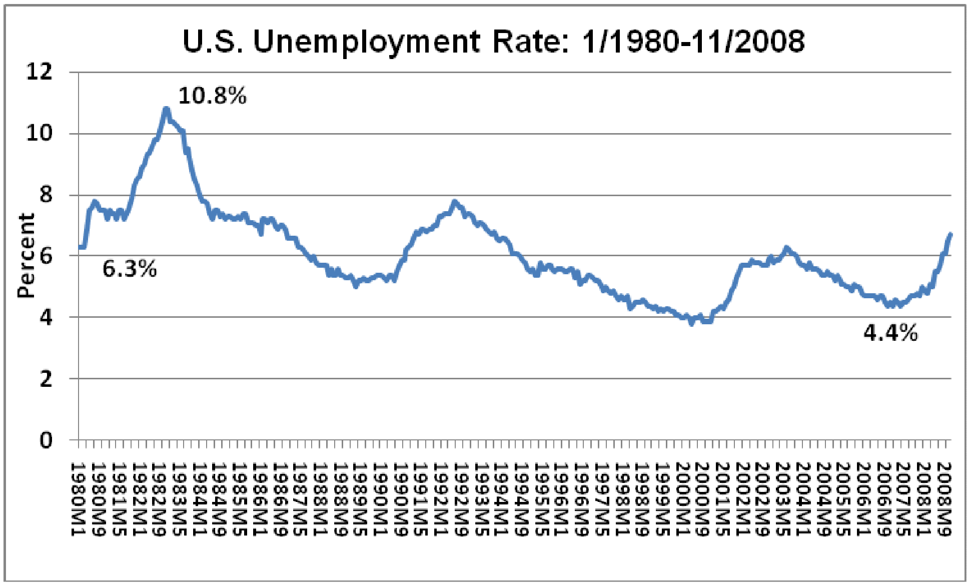


The analysis suggests slow growth will continue until roughly April 2010 and shows an average Industrial Production decline of 6%. The nation will experience anemic Industrial Production and GDP growth that will begin to show strength in the first half of 2010.

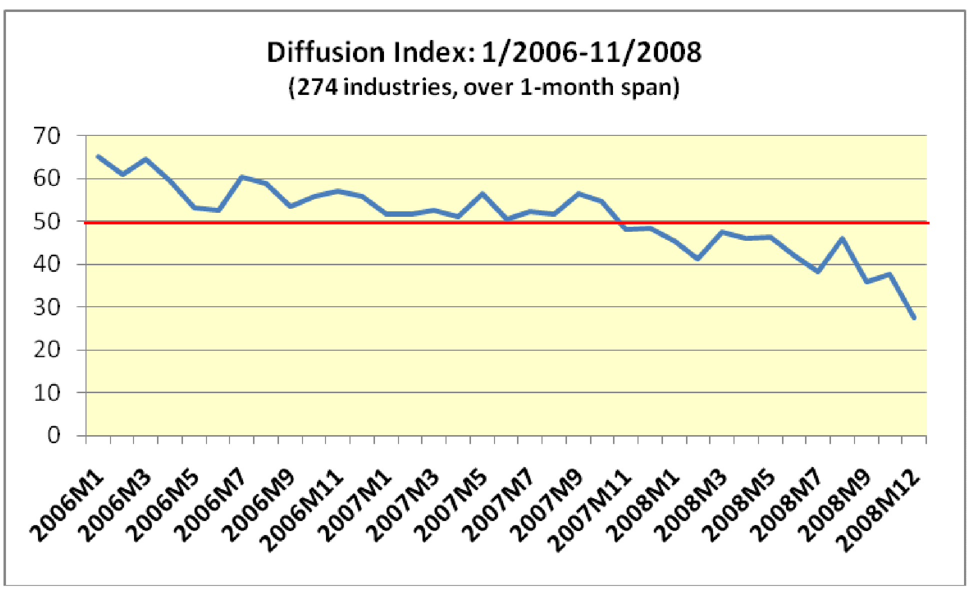
What about labor market effects.

What about the unemployment effects? Consider the next chart. When the 1982-83 recession occurred, national unemployment rose from a base of 6.3% to 10.8%. Of course, this is not your father's economy, as some might put it. We are no longer as labor intensive in the more vulnerable manufacturing sector, but this does not eliminate the unemployment risk that comes from the waves generated when production falls. The unemployment rate at the outset of the current recession was 4.4%. If we add 4.4 percentage points to this initial level, the same increase seen in 1981-82, we should expect to see the rate peak at 8.8%, and at around June 2009. In short, there is more pain to come.

I hasten to note that the causes of the current credit collapse are totally different from the actions that initiated the 1981-82 recession. Nonetheless, the process by which the economy knits itself together again in the immediate recovery period will be strikingly similar. Political steps taken to bailout banks, private firms, states and municipalities will have effects long after the recovery is underway.

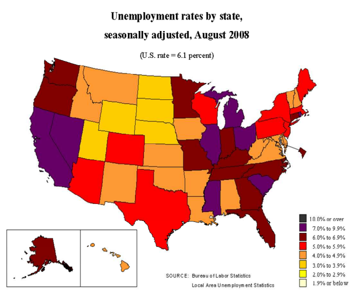


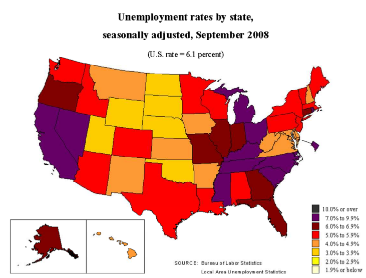
Examination of the employment diffusion index gives another dimension to consider. The index shown in the next chart measures employment growth diffusion across 274 U.S. industries, with growth measured across a 30-day period. When as many industries are expanding as are contracting, the index reads 50. A reading less than 50 indicates contraction. The smaller the number, the more widespread the contraction. Notice the November reading is 27.6, which is remarkably weak.

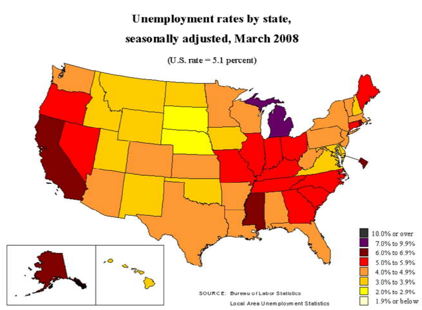


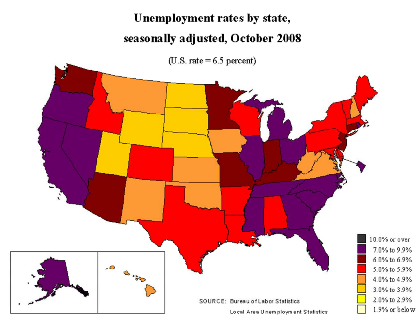
The geographic impact

How employment contracts across industries is an important reading of economic health. But how unemployment spreads across the 50 states tells us how states and regions are weathering the recession. We see this in the next series of charts that shows state unemployment rates for four months. Higher unemployment takes on a darker hue. The sequence should be scanned from the southwest corner, which is for March 2008. Notice how the recession spreads between March and August (in the northwest corner). States continue to darken in September and then in October. By then, the states in the energy-producing regions form the remaining strong part of the economic engine. .

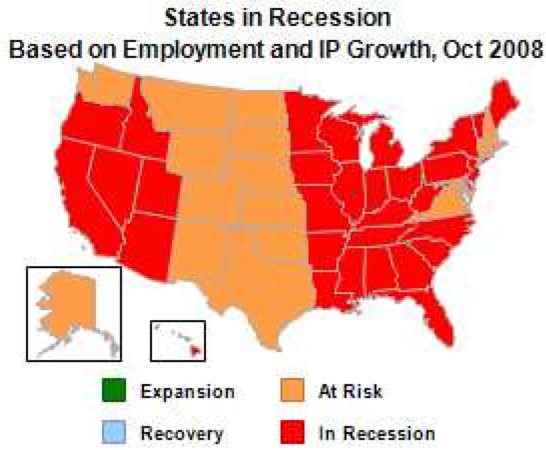








The overall result of this is seen in the next outline map produced by economy.com. Here we see states in recession based on unemployment and industrial production data.

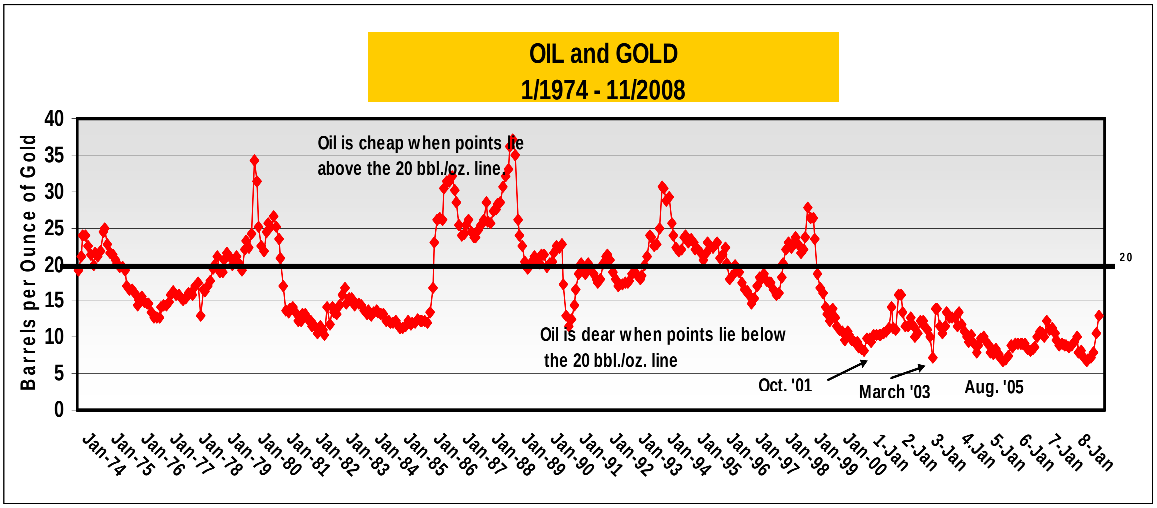


Oil and gold.

Recent dramatic declines in oil prices have generated a much needed boost to anxious U.S. consumers. While a reduction in gasoline prices and home heating costs are welcome for any reason at all, it may be useful to recognize that a meaningful part of the apparently cheaper energy springs from the work of a stronger dollar and monetary forces. But there is another part of the price decline that is real, which is to say that a part of the price change is not related to monetary conditions but to reductions in demand.

The familiar chart below shows the price of oil in terms of gold, one commodity for another. The chart is organized to show how many barrels of oil can be purchased with an ounce of gold. The dark line at 20 barrels marks a historic relationship—an ounce of gold buys 20 barrels of oil. Across many years, the price of oil has fluctuated around that line. In recent years, wars and hurricanes have raised the price. As can be seen, since 2001, an ounce of gold has purchased around 10 barrels of oil.

But notice the last three observations, those for September, October and November of 2008. The real price of oil has fallen significantly. Indeed, if we optimistically use the price of oil and gold fetched on December 4, the ratio would be located almost at 20 barrels for an ounce of gold. In other words, the price is headed toward the historic relationship—20 barrels of oil for an ounce of gold.



Building a knowledge economy index for southern cities.

While the recession, bailouts, and a new administration are understandably on everyone's mind, there is still a new economy forming. This past summer Kristine Koutout, a Clemson economics graduate student, and I began a project with the goal of building a knowledge economy index for a sample of 114 southern cities. We wanted to learn the geography of the knowledge economy. Which are the leading cities?

With funding provided to Kristine by the South Carolina Research Authority, we built statistical models based on explaining variation in per capita income across the sample of cities. Our latest model uses as explanatory variables educational attainment, the count of fast growth firms, and research and development expenditures. While our work continues, I report the top 50 cities we identified in our research.

Southern MSA Knowledge Economy Index

MSA	State	Rank
Austin	Texas	1
Charlottesville	Virginia	2
Lexington	Kentucky	3
Raleigh-Durham-Chapel Hill	North Carolina	4
Atlanta	Georgia	5
Huntsville	Alabama	6
Gainesville	Florida	7
Tallahassee	Florida	8
Charlotte-Gastonia-Rock Hill	North & South Carolina	9
Richmond-Petersburg	Virginia	10
Fort Walton Beach	Florida	11
Columbia	South Carolina	12
Naples	Florida	13
Dallas-Fort Worth-Arlington	Texas	14
Jackson	Mississippi	15
Norfolk-Virginia Beach-Newport News	Virginia	16
Orlando	Florida	17
Melbourne-Titusville-Palm Bay	Florida	18
Asheville	North Carolina	19
Sarasota-Bradenton	Florida	20
Auburn-Opelika	Alabama	21
Charleston-N. Charleston	South Carolina	22
Houston-Galveston-Brazoria	Texas	23
Wilmington	North Carolina	24
Cincinnati-Hamilton	Ohio	25

Southern MSA Knowledge Economy Index

MSA	State	Rank
Greenville	North Carolina	26
Oklahoma City	Oklahoma	27
Savannah	Georgia	28
Little Rock-North Little Rock	Arkansas	29
Jacksonville	Florida	30
Nashville	Tennessee	31
Knoxville	Tennessee	32
Fort Myers-Cape Coral	Florida	33
Tampa-St. Petersburg	Florida	34
Birmingham	Alabama	35
Hattiesburg	Mississippi	36
Lubbock	Texas	37
Tuscaloosa	Alabama	38
Greenville-Spartanburg-Anderson	South Carolina	39
Tyler	Texas	40
Louisville	Kentucky-Indiana	41
Montgomery	Alabama	42
Pensacola	Florida	43
San Antonio	Texas	44
Tulsa	Oklahoma	45
Athens	Georgia	46
San Angelo	Texas	47
New Orleans	Louisiana	48
Memphis	Tennessee-Arkansas-Mississippi	49
Fayetteville	North Carolina	50

The purple shaded cities have a common characteristic: They each contain a major research university and/or a major medical university. Note, for example, that Greenville, NC, ranks above Greenville, SC.

The data suggest strongly that cities linked to research universities and medical centers will be knowledge economy leaders. We interpret this to imply that an innovation/entrepreneurship culture develops in major research communities where knowledge is produced and then embodied in new commercialized products and services that in turn create wealth.

A good read on the Great Depression.

For obvious reasons, there is considerable interest being shown in the Great Depression, its cause, effects, and policies adopted in the hope of easing the associated severe pain. Born in 1933, I have a very personal interest in this period of our history and like many other Depression babies enjoy reading about that difficult time. Recently, a truly outstanding book on the period was called to my attention by Skip Sauer, Chair of Clemson's Economics Department. The book, *The Forgotten Man*, by Amity Shlaes, is delightfully organized and beautifully written.

The story begins with the Hoover years and goes forward to the early 1940s. The author develops her story around a cast of characters who play major roles in politics, industry, and labor. Of course, FDR is the major player in the story, which provides a lively account of his efforts to attempt any government program that offered even a prospect of revitalizing the economy. The somewhat frantic efforts exerted at the time remind one of the current period. It was not clear then and certainly not now how government might play a meaningful role in repairing the economic engine without at the same time building a situation where future engines would require regular political feeding. It was the case then as now that capitalism, the imperfect process that had created great wealth and freedom was viewed suspiciously and at times contemptuously.

I recommend Amity Shlaes' *The Forgotten Man*, New York: Harper Perennial, 2007, and hope that you will enjoy the book as much as I have.

Final thoughts.

We Americans are again caught up in a frantic political process that seeks to repair an impaired economy. At the simplest level of explanation, the problem we seek to address is caused by the institutional arrangement human communities have devised for getting money into the economy. Commercial banks worldwide form the transmission mechanism human beings developed to expand and contract credit and the supply of money. As we all know, the transmission has slipped, locked up, and is beginning to work again, albeit at a reduced level.

Our elected representatives have tried first to understand the workings of the transmission and then to promote various elixirs that might get it going again. So far, the results have been extraordinarily costly. But we should expect this to be the case. As Nobel laureate Frederick Hayek put it, we are tempted by a "fatal conceit" to believe that the collected wisdom of Congress and the best in Washington—or anywhere else—could, first, have the practical knowledge to comprehend the key workings of the global transmission, let alone ,secondly, to generate an effective repair. But belief in command and control is the STP of political leaders, who weekly announce another program or version of an older one in the hope that it will fix the transmission. Unfortunately, each new announcement introduces another large dose of uncertainty in markets world-wide where ordinary people are about to renegotiate loans, reorganize firms, or in other ways fix their part of the transmission.

The political decision to move away from using auctions with taxpayer money to purge financial firms' balance sheets of sub-prime mortgage assets, with the hope of earning a return on the investment, and to move instead toward selected bailouts, opened the door to the tribulation of the fatal conceit. Instead of allowing an impersonal auction with many independent players to distribute funds in exchange for real assets, we see the best and the brightest anointed to pick winners. And of course, once bailouts are announced for one chosen group, there is an understandable cry from the unselected groups to be included. After all, the bailouts thus far have been about salvaging shareholder wealth while seeking to repair credit markets, and that gets downright personal.

Meanwhile, there is "the forgotten man," as Amity Shlaes' story put it. There is the average American who has worked hard to support hearth and home, who pays his bills, and his taxes, and who knows deep down in his heart that it just isn't right to take more of his (or his grandchildren's) money and use it to bail out investors whose businesses have fallen on hard times—sometimes due to their own bad decisions.

It is for this reason that in our imperfect world, the use of public works projects, even if misguided, to juice the economy is somehow more acceptable to the forgotten man than taking future taxpayer money and passing it out selectively to banks, insurance companies, auto companies, municipalities and states, no matter how appealing the calls for help may sound. In one case, taxpayers somewhere may end up with stronger bridges, better roads, and new rooms at the schoolhouse while they will have lost what they would have gained with their money if it had not been taxed away. In the other cases, shareholders of the assisted firms, taxpayers in the favored cities and states, and the politicians who lobby for them will be thankful that they somehow dodged the bullet. And unfortunately, all may have learned a new income transfer strategy that in the longer run reduces the wealth of the nation.